The University of Chicago

POSSIBILITIES AND LIMITATIONS OF INVESTORS' SERVICES

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE SCHOOL OF BUSINESS
IN CANDIDACY FOR THE DEGREE OF DOCTOR
OF PHILOSOPHY

1936

By
DELBERT HARLOW KERCHNER

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POSSIBILITIES AND LIMITATIONS OF INVESTORS' SERVICES

DELBERT HARLOW KERCHNER[1]

PART I. SHORT-TERM TRADERS' SERVICES

THE purpose of the study on which this article is based was to explore the comparative usefulness of different kinds of investors' services, in the hope of finding an objective distinction between the more and the less promising types of service which might be of assistance to investors in selecting the best type of service for them, and might be helpful to the service enterprises themselves in making their facilities more useful to investors.

One portion of the study involved analysis of such distinctions as are to be found in economic literature, the most notable of which is that between factual and forecasting services. One of the extreme advocates of this distinction is Oskar Morgenstern, who does not deny the usefulness of factual services, but argues in detail that there is little hope of ever producing reliable forecasts in the field of economics, especially by services which make their predictions available to the public.[2] This possible distinction is

[1] This article is based on Mr. Kerchner's Doctor's dissertation.

[2] Oskar Morgenstern, *Wirtschaftsprognose* (Wien: Julius Springer, 1928). Cf. Benjamin Graham and David L. Dodd, *Security Analysis* (New York: McGraw-

disposed of in an unpublished portion of the study by demonstrating that the difference between factual service material and forecasting material is a difference of form only. A service may express substantially the same information either as a forecast or as a statement of fact from which the investor is expected to deduce his own forecast. Since all investment depends upon the future for the expected profit, the only service material which can possibly be of use to investors is that which sheds light, either directly or indirectly, upon the prospects for such profit.

After testing all distinctions which have been found in published literature, or have been suggested by investors or by service enterprises themselves, one is submitted here as more tenable and more useful than any other which has been found. Services are divided into two classes, called "short-term" and "long-term" operators' services, according to the objectives of the clients whom they attempt to serve. To avoid confusion readers must note with care the precise distinction between these two types of investment objectives.

All market operators are classified as short-term or turn-in-the-market operators who stake their money upon the next ensuing movement of the market of any particular magnitude or duration; those are classified as long-term or intrinsic-value operators who disregard (or reduce to minor consideration) the next ensuing market movement. The latter group includes many conservative investors who disregard all market movements as a source of profit, relying entirely upon dividend and interest return, but it also includes those avowed speculators who hope for large market profits upon securities or commodities purchased when the price is considered "cheap" if, when the purchase is made, they are prepared to follow their convictions and hold their positions even though the first market movement is adverse. On the other hand, the trader who buys only when he expects the first market movement to be upward and is either not able or not willing to disregard an unexpected decline will be considered a short-term operator even though he may have formed an estimate of the

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Hill Book Co., Inc., 1934). Contrast William Wallace, *Business Forecasting and Its Practical Application* (3d ed.; London: Sir Isaac Pitman & Sons, Ltd., 1932).

probable earning power of the security and this estimate may have influenced his forecast of the market.

The philosophy underlying the methods of the two groups is inconsistent. This is seen if the market declines after a purchase is made. The true long-term operator who has relied upon his judgment concerning the earning power of the security or its prospects for appreciation over a long period of time, irrespective of intermediate fluctuations, will not be disturbed by an unexpected decline in the market. If he does anything about it he will purchase an additional commitment, on the theory that if the stock was cheap before it is now cheaper. On the other hand, the short-term trader has reason to be disturbed because the decline in the market indicates that he was wrong in his judgment. Many of these traders follow the policy of "protecting" each purchase with a stop-loss order at some particular distance under the purchase price, on the theory that it is better to take a small loss than to risk the prospects of a large one. It is illogical for them to average down costs with additional commitments, just as it would be illogical for the long-term investor to sell merely because the market declined unexpectedly.

In its broad scientific aspect this distinction is one between those investors, on the one hand, who operate as if they knew a particular future fact, such as whether the next important movement of the market will be upward or downward, and, on the other, those who operate as if they rely only upon what they consider known qualities or tendencies and avoid placing themselves in such position as to lose if unforeseen forces or circumstances interrupt those tendencies from time to time causing temporary fluctuations. The known qualities on which some of the latter rely include earning power of investments; the concept which many of them call intrinsic value, which is a capitalization of estimated earning power; and various others. The tendencies include business tendencies as well as market tendencies. Apt examples are those tendencies of prices or other business conditions to adjust themselves toward a state of equilibrium, such as is discussed by Alfred Marshall and other economists. Such tendencies may be expressed in terms of general forecasts but they do not

justify specific forecasts of the turning-point of the market or of the direction of the next movement or of any other specific fact at a particular time.

Therefore, the writer takes issue with Morgenstern, not so much in what he says about the futility of specific forecasting, as with his assumption that specific forecasts are the only types of prediction which may be useful. One might better say that although scientific methods may be applied to determine the enduring qualities of things and their tendencies to perform in certain ways, the scientific attitude requires that one recognize the possibility that particular future events may be influenced by unforeseeable forces or circumstances. Hence scientific principles demand that one employ methods of operation in business or investment or elsewhere founded upon that which is known concerning the future, much or little as it may be, and that he protect himself, as best he can, against that which is unknown. The long-term operator often assumes this scientific attitude, trying to rely upon enduring qualities and known tendencies and attempting to protect himself against the unknown, whereas the typical short-term trader stakes his money upon a more specific future event as if he knew that it would occur before some other event.

In this article the attempt is made to demonstrate the principal limitations which necessarily apply to all short-term traders' services. It will be seen that these limitations apply to factual services with almost as great force as to forecasting services.

In the sequel to this article which will appear in the next issue of this *Journal* the longer-term services will be discussed. It will be seen that they are free from most of these limitations which beset short-term services. Within the class of long-term services there seems to be almost unlimited possibilities of useful service to investors and to society, not only by supplying facts, but by issuing forecasts and advice as well.

SHORT-TERM TRADERS' SERVICES DEFINED

Most of the large statistical organizations issue certain statements of facts, forecasts, and advice which may be used by both long- and short-term operators and issue other material which is

designed especially for the one or the other group. In the present article consideration is given only to such subject matter as is directed toward and accepted exclusively by the short-term traders. This includes forecasts of the near term course of the market or the turning-points of the market, but excludes forecasts of the longer term extending through periods long enough that the short-term traders should be expected to change their positions (buy or sell) within them. It includes facts and advice to be used by the trader in such forecasting for himself; thus it includes technical information concerning the market but excludes facts and advice pertaining to the intrinsic value of securities and pertaining to long-term tendencies.

Among the services which fall almost exclusively within this class are a number of forecasting services of the market letter or bulletin type. Since all the fraudulent and tipster services almost invariably appeal to the get-rich-quick instincts of the public, they must fall within this class, but so also do many others whose good faith is not questioned.

CHANCES OF PROFIT TO TRADING PUBLIC

In order to understand the functions of short-term traders' services one must first recognize that the potential profit of the average short-term trader is less than that which is commensurate with the risks involved. There are three reasons for this:

First, trading is a competitive game; it produces no new wealth. Although some traders may gain a profit, someone else must sustain a loss to offset each gain. The greater the profit of the successful traders, the greater must be the loss of others.

Second, trading consumes a substantial amount in brokerage fees and related expenses. Although these fees may seem small in proportion to the maximum possibilities of profit, they create a constant drain upon the total trading-fund and thus reduce the profit of the average trader.

Third, the short-term trading public labors under a technical handicap as compared with the long-term investing public. In order for the former group to gain a profit from the latter they must induce the latter to buy when traders wish to sell and sell when they wish to buy. This is not easy. Even assuming that

long-term investors may be induced to buy certain securities after a sharp rise in price, it is inconsistent with their philosophy to part with those holdings at lower levels unless they are convinced by evidence other than the performance of the market itself that the holdings have lost their "value" as determined by earning-power. Assuming other things to be unchanged, there will always be a larger number of long-term investors willing to own a security at forty than at fifty, and a still larger number willing to own it at thirty, etc.

The theory of many short-term traders is that they can detect accumulation and distribution on the part of long-term investors; and that such periods of accumulation mark proper periods in which to buy, whereas such times of distribution are proper times to sell. This theory assumes that long-term investors are accumulating stock during the lower portion of each major price cycle and are selling it during the periods of overspeculation. If traders are correct in this theory, then the only possible conclusion is that the average of the long-term operators is making money from short-term traders rather than vice versa.

Therefore, the problem of all enterprises attempting to serve short-term traders resolves itself into that of giving their clients enough better chances of profit than those of the average trader to overcome this tendency toward losses.

One must recognize also that the total funds of the short-term trading fraternity would soon be exhausted if they were not replenished from time to time from outside sources. There is, however, an irregular flow of new funds to the market from other sources such as the profits of industry and savings of small investors. This influx of new funds is, of course, irregular, but it constitutes an important market factor and one which tends to obscure some of the tendencies discussed below which would otherwise be easily seen.

DECLINING TENDENCY OF PROFIT TO AVERAGE CLIENT

Success on the part of any particular service enterprise tends to defeat itself. Either actual or apparent profits derived by the clientele of a successful service tend to attract other clients. As

the clientele grows in size and in ratio to nonsubscribers from whom profits are extracted, the potential profit of the average client is reduced. If one assumed that the entire trading public might join the clientele of the most successful service enterprise, the profit of the average client would be reduced to a level at which it would clearly be less than commensurate with the risks involved. Over a period of time losses would exceed profits by an amount equal to trading-expenses plus such gains as were made by long-term operators.

A similar result is produced in other ways without actual increase in the number of clients of the most successful service. All profits obtained by its clientele must be drawn from the funds of less successful operators. This flow of funds from the exploited group to the more successful group reduces the profit possibilities of the average client in terms of percentage of funds employed. Furthermore, unsuccessful traders are constantly being discouraged and driven out of the ranks of the short-term trading-group. Some of them join the ranks of the long-term investors, whereas others leave the market entirely.

This tendency for successful services to defeat themselves would be clearly seen by the public if it were not obscured by constantly changing circumstances. The influx of new funds to the market from time to time creates a source of new profits for the most successful traders. Also profits arise from anticipation of changes in earning-power and intrinsic values of securities. Since these sources of profit are not created by the short-term traders' services, however, they may be disregarded here. In the sequel to this article, however, it will be seen that the anticipation of changes of intrinsic values of securities, as determined by earning-power, is one of the principal functions of the longer term type of service.

ILLUSTRATION OF THIS TENDENCY

In order to illustrate this tendency let us assume that one forecasting service in this class became "perfect" in the function which it has undertaken. It has become able to "call" each turning-point in the market at the proper time for traders to change

their position upon it. It is assumed, however, that this service does not attempt to forecast the trend of the market farther into the future than is necessary in order for clients to buy or sell upon each turn in the market as it occurs. Neither does this service attempt to determine intrinsic values or to advise clients to refrain from trading upon such turns of the market as are away from intrinsic values. For the time being we will also exclude by assumption the possibility of the action by the clients of this "perfect" service influencing other traders or long-term operators to buy or sell, but it is assumed that the clientele itself buys when the service predicts a rise and sells when it predicts a decline.

Under these assumptions it seems clear that a successful forecast would produce greater profits for a single client who might have exclusive use of it that it would produce for the average of two clients or hundreds or thousands of clients. The one exclusive client would be able to use the "perfect" forecast as a guide to buying stock at the cheapest possible eighths and to selling it at the highest possible eighths on each turn. If there were two or more clients there might be less stock offered at the cheapest eighths than they would wish to buy. The larger the clientele acting on these "perfect" forecasts, the higher the price which would be paid by the average client when they bought and the lower the price which would be realized by the average client when they sold.

Hence, assuming the greatest conceivable degree of skill in this type of forecasting, and assuming no interference from outside forces, one must see that the potential profits of the average client tend to decline with every increase in clientele, however small. If it is any consolation to this class of services, one may point out that under these assumptions the clientele of a service might become very large indeed before all possibilities of profit to the average client would be destroyed, but these two important assumptions are, of course, never true to fact. No service can hope for such "perfection" and it is futile to hope that other forces will not interfere with some of the potential profits. The important principle, however, cannot be avoided, that, *under even the most favorable assumptions of "perfection" of forecasting and no interfer-*

ence from outside forces, the potential profit to the average client of short-term traders' services tends to decline with every increase in clientele until profits are replaced by losses.

CHANCES OF BEING RIGHT

Services very seldom advertise the profit derived by their average clients. They usually rely upon claims that they have been right a majority of the time or that their forecasts presented profit possibilities (for a single client) of some specified amount. Also, statistical studies of the success of such forecasting services have usually been confined to testing their records against the performance of the market to see if the market moved in the direction of the forecast. Such claims on the part of the services and such statistical tests of their success are fallacious for two reasons. First, they often seem to embrace the assumption that there is no limit to the possibilities of correct forecasting on the part of the services, under 100 per cent perfection. In reality the group of short-term forecasters, under present market conditions, cannot possibly attain a record approaching such perfection. Although any one service might, conceivably, attain a record near "perfect" for a limited period, if judged only by the subsequent performance of the market, the group as a whole is not likely to attain a record much over 50 per cent correct for any protracted period of time, and there is greater likelihood of its being under 50 per cent correct than over.

Excluding from consideration, for the moment, purchases and sales by long-term investors and forced sales and purchases by short-term traders who have insufficient margins, most other transactions by short-term traders are made in reliance upon short-term forecasts of rise or fall. In order for a sale to occur between two short-term traders, the one usually must expect the market to rise and the other must expect it to decline. If the short-term trading-group constituted the entire market, there would always be as many forecasts erroneous as correct. In fact there would be more wrong than right if both the buyer and the seller were scored as wrong when the market failed to move in either direction. In other words, if all forecasts of rise and of fall

in the price of a stock were weighted by the amount of money with which they are backed up in the market, the average record of the short-term forecasters would be exactly 50 per cent correct unless both buyer and seller were scored as wrong because the market failed to move, and in that case the average record would be less than 50 per cent correct.

To give consideration to the sales and purchases of long-term operators, which were ignored above, does not materially improve the prospects for the short-term forecasters. In fact, it seems to make their prospects even poorer than 50 per cent because we have seen that over a protracted period of time the long-term group seems to have a moderate advantage over their short-term competitors.

In any event, the effect of the purchases and sales of long-term operators would not greatly change the probable percentage of error of the average short-term forecaster as long as the short-term fraternity is substantial in size and in proportion to the long-term group, because the slower turnover of stocks by the long-term holders always tends to spread their purchases and sales so that they have only minor effect at any time. If the average period of retention by long-term investors is ten times as great as the average period of retention by short-term traders, the latter group might account for the major portion of the trading even though the longer-term investors held much over half of all active stock issues. That being true, the net effect of all operations by the long-term group probably does not greatly change the prospects for short-term forecasters, but what effect it does have is probably to reduce the prospects for accuracy of short-term forecasts rather than to increase them.

So, also, with forced sales and purchases among inadequately margined accounts. Their net effect, in normal times, is not enough to alter greatly the prospects of success to the average short-term trader.

One may, of course, argue that the forecasts of the services might be more than 50 per cent correct if those of nonsubscribers fell substantially below that level. True, such a situation might exist for a limited period of time, but if the services advertise their records and do not try to limit their clienteles they will soon

attract the unsuccessful nonsubscribers or drive them out of the market.

The same principle applies to each service individually. If any service in this class gains an enviable record for a period of time it is likely to loose it rather quickly when it advertises it. This will become more clear to readers after the discussion of repercussions below.

PSEUDO-FORECASTING

There is another reason, and a very important one, why investors must be skeptical of a service which points with pride to its "perfection" in short-term forecasting and cites instances in which the market rose after it predicted a rise and fell after it predicted a decline. Such a rise or fall of the market may not indicate one iota of forecasting ability on the part of the service. And it may not indicate one cent of profit to its average client. If all other factors were merely neutral, such a rise and fall of the market would be the natural consequence of the forecasts if they are acted upon by a substantial clientele.

Assume that all other factors are neutral—that in the absence of the forecast by the service the price of a given stock would have remained unchanged—under these circumstances the service forecasts a rise in the price of that stock. In so far as it influences its clients to buy, the direct effect of their purchase orders is to advance the price of the stock. When the clientele of the service has bought and the price is up, the service may predict a decline. Again, the sales by the clients themselves tend to depress the price.

If no one outside the clientele of the service had been influenced by the market flurry the price would come to rest at approximately the same level at which it started. Under these assumptions the result would be a net loss to the average client of an amount sufficient to cover brokerage fees and other direct costs of trading including the difference between bid and asked prices. The brokers would have profited and some few of the clients might have profited at the expense of others but the result to the average client would have been a net loss. Nevertheless the record of the service would look "perfect."

The direct effect of the buying and selling by the clients of a

service, if they follow its predictions, is to cause the market to move in the direction of the forecast, but this direct effect tends to bring them loss instead of profit. Unless some other source of profit can be found, the clients of a service may always suffer losses even though its forecasting record looks perfect.

This seems to be one of the most difficult points for the public to understand—but its very simplicity should enable everyone to see it. Investors sometimes accuse a service of "fraud" because it advertises a high degree of "perfection" of forecasting, whereas investors who have tried to follow its forecasts have sustained losses. A certain enterprise which advertises widely and must have a large clientele has received much adverse criticism of this character. Its advertising literature, which was examined by the writer, claims merely that it successfully called the turns for a period of time. The service does not state that its clients made money and, obviously, it could not determine that fact because it does not expect its clients to report all their purchases and sales. Clients of that service report losses and claim that they prove its advertising to be fraudulent. To the present writer the facts reported by the investors seem equally consistent with the probability that the clients of the service are numerous and are gullible and have been buying in substantial amounts when the service predicted a rise and selling when it predicted a decline.

Until every investor recognizes these truths, let us repeat that *in so far as the clients of any service buy when it predicts a rise, they tend to advance the market, and in so far as they sell when it predicts a decline, they tend to produce that decline. Such buying and selling* (other forces being neutral) *produce only losses and no profits for the average client, although the service may gain, thereby, a record which is apparently perfect.*

In order for forecasting of the short-term variety to produce profits to the clientele of a service the forecast of a rise in the market must be followed by a rise after the clients have bought. This rise must be sufficiently large and vigorously supported by nonsubscribers to enable the clientele to sell later at a profit. Conversely, a forecast of a decline must be followed by a decline far beyond that which is produced by the selling of stock by the clientele itself. In order for such a decline to be utilized for a

"bear" operation (a short sale and cover transaction), the market must continue down after the sales by all clients of the service have been executed and must remain down while they cover their short positions.

Whenever a service advertises that the market rose a certain number of points, perhaps ten points or fifty points, after it predicted a rise, one may be certain that some part of that rise, possibly all of it, was pseudo-forecasting, or the effect produced by purchases by the clientele itself. Part of the rise was, probably, the manipulative effect produced by the sympathetic purchases by nonsubscribers. A part may, perhaps, be the rise which would have occurred if the forecast had never been released, but it is equally possible that the market might have moved in the opposite direction had the forecast not been released.

Therefore, the fact that the market did rise ten points or more after the prediction was published does not prove the service possesses forecasting ability. Neither does it prove that its clients profited. If they bought in response to its prediction they produced part of that rise, perhaps all of it. If the part which was produced by the clientele was substantial in proportion to the total rise, it is likely that those clients who bought would not be able to sell without depressing the market to a level at which they would not obtain a net profit.

If the rise which materialized was only ten points, the one certain conclusion which can be drawn from that fact is that no client profited by an amount greater than ten points less expenses of trading. The result to the average client must have been poorer than that potential profit to a single client. If the clientele were large it is probable that the result to the average client would be unsatisfactory and might even be a net loss.

Therefore, mere comparison of the forecast with the performance of the market is always overfavorable to short-term forecasting services. Such tests give the forecaster credit for the element of pseudo-forecasting which represents neither forecasting ability on the part of the service nor profits to its clients.[3]

[3] Cf. Alfred Cowles, III, "Can Stock Market Forecasters Forecast?" *Econometrica*, I (1933), 309–24.

MANIPULATIVE TENDENCIES

Above, the fact has been emphasized that each market movement is the effect of sales and purchases. Now we turn to its influence upon the public. Each market movement tends also to cause further purchases and sales. Manipulative tendencies are the natural manifestation of the human instinct to follow the crowd.

When the clients of any service buy a stock (or any number of stocks) they tend to advance the market; this advance tends to attract the attention of other members of the trading public, some of whom will be likely to join the buying wave and thus raise the market still farther. The larger the clientele of the service, the greater is likely to be the rise in the market when its clients purchase stock and, therefore, the more noticeable that rise will be to other members of the trading public, but, also, the greater the public following which must be attracted before the average client of the service will be enabled to sell his holdings at a profit without depressing the market.

Every service enterprise which influences clients to buy or sell securities or commodities has more or less manipulative influence upon the public, whether it intends such an influence or not. Counselor services, however, have an opportunity to minimize this effect by varying their advice to different clients, and many of them do so, particularly because they are interested in long-term objectives rather than in producing market flurries. Printed services, however, and all other bulletin services of the form-letter type have less opportunity to avoid this effect of their predictions or advice. Although it is assumed that no reputable enterprise predicts a market movement for the purpose of influencing the market, investors must recognize the possibility that enterprises of questionable integrity might do so. On the other hand, it would seem likely that most deliberate manipulators would use the pool type of organization rather than the service type because the former offers several distinct advantages, such as secrecy and control over trading technique, which are not offered by the service form of organization.

The analogy of the children's game of crack-the-whip may help readers to visualize the place of the clientele of a traders' service

in a trading cycle. A trading cycle may be defined as any movement of sufficient size that traders would be expected to use it as the basis of a complete operation, either purchase and sale or short sale and repurchase. In the interest of simplicity it will be described here as if it started with the upward movement. The question is whether the clientele of a traders' service is likely to gain a position near the base of such a movement, the position which is analogous to that at the butt of the whip in the game.

Unless the service is deliberately trying to manipulate the market, it is likely that it will not predict a rise in the market until evidence is seen that the rise is already under way. When that has taken place it is too late to gain the preferable position at the base of the movement, at the butt of the whip. Clients of such a service will join the movement after it has been started by manipulators or by long-term investors. In either case they obtain a distinctly inferior position. But the manipulative effect of their purchases may attract other members of the public to join the movement after themselves. Their prospects of success depend directly upon the relative number of such trailers who follow them in the movement. If a large public following is attracted, the movement may be carried far enough that the clients whom we are considering may be able to sell at a satisfactory profit to others who are still eager to buy. But in the market cycle, just as in the children's game, those strong interests which start the movement and gain the ideal position in it have the advantage in selling and thus terminating it. The technique is for them to start selling while the manipulated members of the public are still buying and are willing to take their stocks off their hands at favorable prices. The last to join the movement suffer most but the effect is usually carried back more than halfway. Only those at the very base of the movement gain a profit approaching the maximum possible profit which has been mentioned above.

Who starts such a trading cycle and thus gains the favorable position in the movement? Several answers to this question might be offered. In the presumably rare instance in which a service enterprise attempts to manipulate the market, it may start the movement and its clients may thus gain a position near the base, but in all other instances in which a trading cycle is started by in-

creased demand on the part of long-term investors, by nonsubscribing members of the trading public, or by pools or other professional manipulators (assuming the existence of such a group)—in all these instances the preferable position in the trading cycle will be gained by those who start the buying movement, and the clients of all traders' services will join it in an inferior position if they join it at all. They will be among the manipulated rather than the manipulators.

REPERCUSSIONS

Just as there is a natural human instinct to follow the crowd, so also in every organized market may be seen evidence of a competitive urge to try to beat the crowd. This urge or impulse gives rise to market phenomena which, for the lack of a more appropriate name, may be called repercussions.

In any large clientele there are always a number of individuals who will try to gain an advantage over other clients by using the service material in some manner other than that which is expected. For instance, after a service has committed several errors some of its clients may begin to think that the service is more often wrong than right. Hence, they may undertake to sell when it predicts a rise and buy when it predicts a decline. A variation of this idea takes the form of the theory that the market is likely to rise a moderate distance as a result of the purchases by the clients themselves and at some later time when they attempt to sell it will be likely to decline. Acting upon such a theory a trader sometimes places his order for a short sale some certain distance above the market when the service predicts a rise. If the predicted rise develops he may benefit by the short sale near its peak and the subsequent decline but if the service is wrong and the market does not advance the distance expected he will have lost nothing. Almost an endless variety of other ways have been found by clients to trade so as to try to gain a profit from other clients of the same service or to gain an advantage over them in seeking profits from the same source.

Furthermore, many pool operators and other professional traders read the principal short-term traders' services, not for the purpose of following their predictions or advice, but for the sole

purpose of making as much as possible out of the clients of those services in every way possible. It is not uncommon for powerful trading interests to be planning a certain operation, then, if a leading service learns of it and announces the coming movement to their clients, the interests which had planned it are likely to change their plans suddenly for the purpose of defeating the clientele of the service and enhancing their own profits. For instance, if the interests had started accumulating certain issues when one or more leading traders' services predicted a rise in the market for those issues, the pool manager might dump stock on the market to cause a temporary decline, or he might snap up all available stock and shoot the market up rapidly, or he might try any of a number of other strategies.

The point is that either clients or others who learn of the announcements of such services often defeat the faithful followers of the service. Such activities may produce market movements consistent with the prediction of the service and even more spectacular, or they may in extreme cases produce movements in the opposite direction. If a rise has been predicted it may be cut short by orders for short sales soon after the clients of the service have completed their purchases, it may shoot up so rapidly that the average client will obtain his stock at an unfavorable price if he attempts to buy, or it may even decline. In direct contrast to the manipulative tendencies, however, all the repercussions are likely to injure the faithful clientele of the traders' service.

CONFLICTING TENDENCIES

It has been seen that the direct effect of the attempt on the part of clients to buy when a short-term traders' service predicts a rise and to sell when it predicts a decline is to influence the market in the direction of the forecast although this response of the market to the orders of the clientele itself does not bring profit to the average client · furthermore, the indirect effect of this market movement upon the balance of the trading public is to generate two kinds of tendencies: manipulative tendencies which augment the movement of the market in the direction of the forecast and help the prospects of the average client, and repercussions which sometimes cause the market to move in the opposite direc-

tion from that of the forecast and always detract from the prospects of profit for the clients. Whether the favorable or unfavorable tendencies will be likely to prevail in any particular instance will depend upon the psychological setting in which the forecast is issued. Of course, the forecasting service attempts to determine what the psychology of the market is before it issues its forecasts, hence one of the major problems of this type of forecasters is to anticipate or "guess" how the professional and nonprofessional trading public will react to the announcements of all traders' services as well as to other news.

But, however well a service may anticipate the public reaction to the conflicting stimuli, it cannot prevent the conflict of tendencies. The conflict itself between favorable and unfavorable tendencies which are set in motion by each announcement of a short-term traders' service has two important effects for investors.

First, it lowers the actual profit of the average client of any traders' service a substantial distance below the maximum possible profit which has been discussed above. We have seen that there is a declining tendency of this maximum as the clientele of the service increases, and now we see that these conflicting market tendencies, which are always set in motion, lower the actual profit of the average client substantially below this theoretical maximum. When the clientele of a service is of such size that the theoretical maximum profit of its average client is quite substantial, these conflicting tendencies may cause the average client to receive an actual loss on each transaction—even under the assumption that the market moves in the direction of the forecast in each instance.

The second important consequence of this conflict of tendencies is to create or augment a situation of market instability and fluctuation. Forecasts of the near term course of the market do not tend to create a state of equilibrium around some particular level. On the contrary they are incessantly setting it in motion.

No matter how high prices may be, they may be pushed still higher by turn-in-the-market traders because the forecasts on which they rely are "bullish" predictions. Much of the buying before the crash in 1929 was undoubtedly performed by traders who were

purchasing in anticipation of further rise in the market rather than in reliance upon estimates of intrinsic value. Although no one can determine exactly how high the market would have risen in the twenties if it had not been for the stimulating influence of short-term traders, it is safe to say that it would never have reached the heights which were witnessed in 1929.

Stop-loss orders entered by such traders to protect long positions and also sales in anticipation of a decline may tend to accelerate a decline after a downward turn has occurred. Such sales in anticipation of further decline carry certain stocks, if not the entire market, down to much lower levels than they would find if no one sold except those who believed that prices were above the level of intrinsic value. There is no doubt of the existence of practical limits for the market as a whole, such as those set by the supply of credit, but the world has witnessed a recent boom and depression in which the upper and lower extremes were very far apart and were certainly farther apart than they would have been without the influence of short-term trading and of services designed for such traders.

ADVISORY SERVICES

The difference between the forecasting form of service and the advisory form cannot increase the maximum possibility of profit to the average client or prevent the operation of the tendency for the potential profit to decline as the clientele increases. But many advisory services limit their clienteles to comparatively small numbers so that the theoretical limit upon the possible profit is very high. However, leaks of information may sometimes occur. When they do occur so that "pools" and other professional traders gain the information which is intended for the exclusive use of the clientele, the beneficial effect of the limitation is entirely lost.

Another possible advantage of the advisory form of service over the forecasting form is that the scope of advice may be broader than that of forecast. For instance, the advice may extend beyond simple purchase or sale recommendations and may include recommendations concerning methods of safeguarding one's self against losses. Errors of trading technique sometimes cause losses

to clients of forecasting services which can be avoided, in part at least, by counselor services. Such losses avoided tend to cause the actual profit received by the average client to approach more closely the theoretical maximum.

A third advantage of the counselor type of service is that most enterprises of this class ask their clients to report purchases and sales to the counselor. This enables the latter to determine the actual profit of his clientele on each transaction. The service can thus estimate the amount of pseudo-forecasting, manipulative tendencies, and repercussions which follow each of its recommendations. Counselors may thus be able to profit by their own past experience to a greater extent than the forecaster for a bulletin type of service who can never distinguish between the market effect produced by his own clients and that which would have occurred if the forecast had not been issued, and can only estimate the probable profit or loss of the average member of his clientele.

A warning is, however, necessary. If short-term traders rush to investment counselors, demanding advice on short-term operations until the great majority of the trading public becomes clients of small counselor organizations, such counselors will tend to lose whatever advantage they now have. May it be repeated that the chances of profit to the average trader are less than commensurate with the risks involved, and this will remain true even though that average trader may some day become a client of an advisory service.

FACTUAL SERVICES

Factual services are also subject to the declining tendency of the maximum possibilities of profit to the average client as the clientele increases. Since factual services are now much more popular than forecasting or advisory forms of service, it follows that the profit of the average client of all factual services combined is probably very small if it is not a minus quantity under present trading conditions.

Unlike counselor services, factual services seem to present no special possibilities of profit to clients which may not be presented in the forecasting form. Contrary to the inferences of Morgenstern and others who have criticized forecasting, it seems that the limitations which are demonstrated above apply with almost

equal potency to factual material as to forecasting material if the investment objective which is being served is of the short-term or turn-in-the-market type.

If certain facts are useful to traders because they imply or indicate the ensuing course of the market, they would seem to have no greater possibilities of usefulness to the trading public than the best forecast which might be inferred from them, but it has been explained that even "perfect" forecasts of the next ensuing movement of the market of any particular size which may be assumed become of no avail when too many people try to exploit them. The tendencies described above as pseudo-forecasting, manipulative tendencies, and repercussions apply to factual services in exactly the same manner that they do to forecasts which are expressed by the service. The source of these tendencies lies in short-term trading rather than in expressed forecasts.

The circumstance which makes these truths difficult for the public to recognize is the fact that the trading public using such factual material is so large that some members of the group make very large profits from time to time. The inference is drawn that the profit derived is entirely dependent upon the skill of the trader. Of course the relative skill of various traders is a very important factor in determining their relative profits. The greater the number of "suckers" or unskilful traders there may be in the market at a given time, the greater may be the possibilities of profit to the most skilful traders who have access to the greatest amount of valuable information. But, as was demonstrated above with forecasts, the profit possibilities which arise from access to the most valuable factual information are limited by the same declining tendency when the number of persons using that information increases. Moreover, the profit to the most skilful users of factual information is enhanced by the manipulative tendency which their operations foster among the less skilful public and it is impaired by repercussions which are constantly being set in motion. No conceivable amount of increase of skill on the part of the trading public can ever overcome the principle that the potential profit to the average member of that body is less than commensurate with the risks involved.

Occasionally a trader or small group of traders discover a new

source of valuable facts, a new application of formerly used facts, or a new trading technique which may seem for a time to give promise of consistent profits. Loose thinking may lead them to believe that the new material is a bonanza which will make a gold mine out of the stock market. As the number of traders using the new facts or material begins to increase, the direct effect of their trading upon the market will also increase and the tendency of other traders to follow the crowd may work decidedly to the advantage of all users of the new facts or method, For a time they may gain a favorable position in each trading cycle. Accompanying the early stages of the increase in number of persons using the new material there may be such an increase in profits to all of them that they may jump to the conclusion that, since a small increase in number of users of the material has resulted in an increase in percentage of profit on all funds employed, a large increase in number of users of the material should result in a still larger increase in relative profits. But no such argument is tenable. The small increase in profits may arise from the working of the manipulative tendency, but as the profit to the users of the material approaches the maximum possible profit (as determined by the ratio of funds employed by the users of the material to those of nonusers) the tendencies described above as repercussions become more and more noticeable. Profits are eventually replaced by losses, and then the users resume their search for new material, new forecasting methods from old material, or a new formula for profits.

An enormous number of short-term trading methods has been developed from time to time. The methods described by Rhea form examples.[4] The discoverer or inventor of such methods often "check them backward" against past market performance for a number of years to try to determine how they would have worked in prior years. Under a misapprehension of scientific methodology, they believe that they are thus proving the "scientific" value of their new methods or formulas. Perhaps they are also tried out with a very small amount of money as a "laboratory test" of their value. They they are published in book form or in the pages of financial periodicals or in the bulletins of trad-

[4] Robert Rhea, *The Dow Theory* (New York: Barron's, 1932).

ers' services. If the objective of the method is within the short-term class of objectives, the result always has been and always must be disappointing to the public. Such methods defeat themselves when employed by large numbers of traders.

RECAPITULATION

Trading on the turn of the market never can be a source of profit to the public. It may be a source of profit to a few who have some advantage over the less fortunate members of the trading group in the form of inside information, unusual skill, or the like, but the essence of that advantage must be kept secret from the public or it will be lost. The idea of a service is to make some knowledge or other advantage available to the many. Therefore, whenever services try to make available to the many forecasts, facts, or advice concerning the turning-point of the market or the ensuing market movement of some particular size or duration, they tend to defeat that advantage itself. Over a period of time each enterprise of this character must fail to produce profits for its clients. The only traders' "service" (if it may be called a service) which can benefit its clients consistently over a protracted period of time must be the one which hides its light under a bushel by offering its fallacies to only a very few individuals who are able to prevent leaks of information to outsiders.

In contrast to the views of Morgenstern, it seems clear that factual services are equally as futile as forecasting services. If the objective is within the short-term class, the objective is futile for the public. Hence any form of service which is designed to facilitate that objective is also futile. The position of Graham and Dodd seems to be similar to that of Morgenstern to the effect that all economic forecasting is unscientific. Their arguments, however, are more applicable to all short-term traders' service material than they are to all stock-market forecasting, against which they are directed. The sequel to this article, which will appear in the next issue of this *Journal*, demonstrates that these arguments which seem so conclusive when applied against the short-term objectives lose most of their potency when applied to longer-term objectives.

[*To be continued*]

POSSIBILITIES AND LIMITATIONS OF INVESTORS' SERVICES—*Continued*

PART II. LONG-TERM INVESTORS' SERVICES

DELBERT HARLOW KERCHNER

IN THE preceding article[1] it was seen that enterprises which aim to serve short-term traders are faced with serious limitations. The ensuing movement of the market is always affected directly by the reaction of the trading public to the announcements of such services themselves, as well as by its reaction to other current events. If one were to judge the success of short-term forecasters by comparison of their predictions with the actual performance of the market, and if one were to weight each forecast with the amount of money which is actually used in trading in reliance thereon, then the percentage of error of all such forecasts would be at least 50 per cent, and it would probably be somewhat higher. Regardless of the degree of skill attained by any particular enterprise, it can never be expected to maintain a record substantially better than this normal percentage of error for any protracted period of time, especially if it advertises its record and accepts as many clients as it can obtain. Furthermore, even such an objective test of success as comparison of the forecasts with the actual performance of the market is overfavorable to short-term forecasters because it gives them credit for the factor called pseudo-forecasting, which indicates neither skill on the part of the service nor profit to its average client. Measured in terms of profit to the clientele, such services will always tend, over a period of time, to produce losses instead of profits. Any particular enterprise may happen to produce profits for its clients for a limited time, but as the public learns of its enviable record, this apparent success will tend to defeat itself and, sooner or later,

[1] This is the second of two articles, the first of which appeared in the *Journal of Business* for October, 1937.

must be transformed into failure. The underlying reason for all these evidences of futility on the part of short-term traders' services lies in the simple fact that trading upon successive movements of the market, of any given dimensions, does not increase wealth but, on the contrary, reduces it by an amount equal to the expenses of trading. It also tends to create or augment market fluctuations and thus affords opportunities for long-term investors to win profits from the short-term trading group. Therefore, in so far as any short-term traders' service influences investors to seek futile objectives, it tends to injure the average member of that investing public, and over a period of time it will fail to benefit its own clients.

Attention is now turned to a fundamentally different type of service enterprise. Services of the long-term type will be found to possess infinitely greater possibilities for benefiting their clients and for enriching the average investor. The underlying reason for the difference will be found to lie in the simple fact that successful investment directly increases wealth. Hence, services which are designed to make investment more profitable benefit society as well as their own clients.

INVESTMENT CONTRASTED WITH TRADING

Investment, by which is meant long-term or intrinsic-value investment, unless otherwise indicated, is fundamentally different from trading upon short-term or turn-in-the-market principles. Investment may be defined as the appropriation of resources to productive capital purposes or to public uses. Purchase and sale of investment securities does not constitute the essence of investment itself; it is only an incident thereto.

As was mentioned in the preceding article, the long-term market operator or true investor keeps his mind primarily upon the productivity of the purpose for which he is appropriating his funds. He studies the past and present earning power of capital in respective industries and companies, and the prospects for the future of each industry and each company. To him market profits are relatively uncertain and, hence, more or less incidental. Of course he is willing to accept such profits when circumstances

make them available, but the conviction upon which he stakes his money is one concerning the earning power or productivity of capital rather than a conviction concerning a market movement.

It may be argued that there is a third class of operators, made up of those who are primarily interested in market profits but who rely upon long-term trends rather than successive market movements. But in practice this group is found to be relatively small if not nonexistent. One may buy a security in the belief that he is interested only in the long-term trend, rather than either intrinsic values or the ensuing market movement; but this belief will be severely tested if the market should decline a great deal after such a purchase. When such a test occurs, many investors who regarded themselves as "trend" operators find themselves studying intrinsic values or current market fluctuations or both. When the trend seems to be against them they usually decide to join either the intrinsic-value group or the trading group. If the former, they hold on to their securities because of a conviction concerning earning power and intrinsic values; if the latter, they sell because of an expectation or fear that the market will decline still further before rising to definitely higher levels.

For present purposes, therefore, all market operators may be classified as long-term or intrinsic-value operators who operate as if they relied upon convictions concerning earning powers and intrinsic values rather than operate as if they relied upon convictions concerning successive market movements. In short, an objective rather than a subjective classification of all operators results in two rather than three or four major groups.[2]

The long-term method of operation involves purchase of securities only when they seem to be cheap in relation to earning power and intrinsic values, and the sale of such securities only when one of these circumstances arises: when they seem to be overpriced in relation to earning power, when funds are shifted to some other security which seems to be priced much more attractively in relation to intrinsic values, or when funds must be withdrawn from the market for business purposes, living expenses, or other-

[2] Cf. Charles H. Dow, *Scientific Stock Speculation* (New York: Magazine of Wall Street, 1920), pp. 17 ff.

wise. If the market declines substantially after the purchase is made, but none of these three contingencies have occurred, these long-term operators either disregard the decline or they increase their commitments and average down costs if funds are available. They do not sell merely because the market has declined.

Contrasted with this method of operation, the short-term method involves the purchase of securities only when the operator expects the next movement of the market to be upward, and the sale thereof either when the operator becomes discouraged because of inactivity or when he expects the next movement to be downward (or when sale is required because of inadequate margin). The "protecton" of purchases with stop-loss orders is a sure indication of the short-term method of operation, whereas the practice of averaging down costs is consistent only with the intrinsic-value method of operation. The mixture of both practices is inconsistent.[3]

LONG-TERM INVESTORS' SERVICES DEFINED

The group of services which is being considered here includes all those which supply material which is used by, or is believed to be useful to, long-term investors. Thus it includes all services which supply facts, forecasts, or advice pertaining to any of the following: major price tendencies, the earnings of corporations, the intrinsic values of particular securities, the prospects for future earnings, prospects for future business improvement or recession, the best methods of operation upon such information as is available, etc. Long-term forecasts concerning prices of securities are most easily confused with short-term or turn-in-the-market forecasts and, therefore, they will be given greatest consideration here in order to bring out the contrast. The stock-market forecasts which are of greatest interest to long-term investors are predictions concerning the probable trends or price tendencies which are supposed to bear some direct relationship to earnings, intrinsic values, or general business activity. For instance, a prediction that prices of securities are likely to reach substantially higher or

[3] Contrast L. L. B. Angas, *Investment* (London: Macmillan & Co., Ltd., 1930), pp. 86–97.

lower levels, in the course of time, because they are expected to tend to adjust themselves to know earning power, would be of interest to long-term investors and would, therefore, be considered a typical long-term forecast.

It must be remembered, however, that long-term forecasts do not include predictions concerning the next ensuing movement of the market. Long-term investors recognize that although stocks may be too high already, the first movement of the market may be upward; and although they may be selling at very low levels in relation to earnings, the next movement of the market may be downward. It is always public enthusiasm or gloom, rather than earning power, which determines the next movement of the market, although in the long run it is probable that public esteem will tend to readjust itself, from time to time, to earning power.[4] Consistent with long-term principles, several well-known investors' services were predicting in 1927 and 1928 that sooner or later the market would break and stocks would again sell substantially lower than the then-existing prices, because it was believed that prices were substantially higher than a reasonable capitalization of existing and prospective earning power. Some of these forecasters did not attempt to predict when the crash might occur and, hence, they were scoffed at by traders. But it must be remembered that any attempt to predict the time when such a turn in the market would occur is classed as a short-term forecast and is subject to the limitations discussed in the preceding article.

It has been found that many long-term investors study technical information concerning the market, which is the principal material studied by many short-term traders. Long-term investors were encouraged to do this by Charles H. Dow because he was convinced that intelligent study of such data provided a useful check upon one's judgment concerning intrinsic values, and it also assisted him to choose the best times to buy and to sell in order to buy most cheaply and to sell at the most attractive prices.[5]

[4] Cf. Alfred Marshall, *Principles of Economics* (8th ed.; London: Macmillan & Co., Ltd., 1936), pp. 592–93; Dow, *op. cit.*, p. 83.

[5] *Op. cit.*, esp. pp. 26–27, 81–83.

Therefore, since technical information is actually used by many long-term investors, it is regarded as long-term service material in so far as it is actually used by them, although its usefulness as short-term service material was considered in the preceding article.

PRIMARY PROFITS

Investing on long-term or intrinsic-value principles is not a game like trading on turn-in-the-market principles, because profit may be earned without a loss being incurred by some other operator. The primary source of investment profit is the earnings or increment of the capital goods which are created or purchased with the funds so appropriated to a productive purpose. Instead of consuming part of the total wealth of society, successful long-term investment increases that total wealth. This productivity of investment is so well recognized by economists that it needs no further argument here. What is not so well recognized is the relationship which exists between the productivity of the investment and the usefulness of such service enterprises as facilitate that type of investment.

Although the profit which accrues to long-term investors from the productivity of capital itself rather than from the funds of any other investors is referred to here as the primary investment profit, or the profit from primary sources, this should not be interpreted as meaning that such primary profits are always the largest profits derived by long-term or intrinsic-value investors. It is possible that this primary profit may constitute only a small portion of total profits, especially when prices fluctuate widely, but it is never forgotten by long-term investors and, under any circumstances, it is regarded by them as more certain than other potential profits. They can gain this profit even if all investors were equally skilful whereas other profits are dependent upon a degree of skill superior to that of other operators.

In so far as investors' services may be able to increase the productivity of capital by facilitating investment upon intrinsic-value principles, they will be adding something to the wealth of society. Their clients should benefit most from that increased

wealth but the investment income of the average investor should also be increased. If, therefore, this class of services can increase the productivity of capital they should avoid the discouraging tendencies which beset the short-term type of services which are merely trying to enable some traders to play a more successful game against other traders.

SECONDARY PROFITS

In addition to the primary profits which arise out of the earnings of the capital goods themselves, long-term investors also derive substantial profits from less successful operators. In the preceding article it was seen that turn-in-the-market operators do not seem to have an even chance to hold their own against their long-term competitors. The fundamental reason is that traders buy even when prices are above intrinsic values if they believe that they will rise still higher before declining, and they sell even when prices are below intrinsic values if they expect further market weakness. In short, they disregard the important economic principle that prices tend, over a period of time, to readjust themselves to a level consistent with a capitalization of earning power. Such disregard of this important principle by short-term traders presents long-term investors with favorable opportunities to buy securities at very attractive prices and to sell them at high prices.

The influence of long-term investors is felt in almost every fluctuation of prices unless it be the very small ones. Trading cycles which are considered by most long-term investors to be too small to warrant both purchase and sale may, at their lower levels, attract a limited number of intrinsic-value operators to think that stock is "cheap" in relation to "value" and they may, at their upper levels, cause other long-term investors to part with stock. Even such trading cycles, therefore, which are not predicted and are not considered of sufficient importance to the long-term investor to warrant a complete in-and-out operation, do afford opportunities for a gradual flow of funds from unsuccessful short-term traders to more successful long-term investors.

On the other hand, the major cyclical fluctuations of the stock market are often regarded by long-term operators as presenting

opportunities for profitable purchases near their lower levels and for profitable sales near their higher levels. No precise definition of the size of such a movement can ever be given because some long-term investors will regard a particular fluctuation as presenting such opportunities at both extremities whereas other investors will regard it as a trading cycle, presenting an opportunity for either purchase or sale on intrinsic-value principles, but not for both. For instance, even at the zenith of the 1929 boom some long-term investors were retaining certain stocks because they believed that even those prices were below the intrinsic value or a reasonable capitalization of the earning power of their particular issues. And even at the extreme low levels of 1932, almost every investor could point to particular stocks which he regarded as overpriced on the market. Many investors of this class regard certain stocks as being entirely worthless, and consider any price too high for them.

It must be recognized, however, that any profits which long-term investors gain from buying securities "cheap" and selling them "dear" are derived from the funds of other less successful operators. Such buying and selling of securities does not directly increase wealth. In so far as investors' services facilitate this end and no other, it must be expected that they will be subject to some of the limitations which were found to apply to enterprises which facilitate turn-in-the-market objectives.

However, the differences between the two types of service are more important than the similarities. In the first place, long-term investors may make such gains from short-term traders without relying upon any specific price forecast of the type which the latter regard as essential. Whether the long-term method of operation requires any forecast at all depends upon the precise definition of forecasting. All that is necessary to this method is that the operator be able to recognize "cheapness" and "dearness" of securities when such conditions exist. In order to do so the operator must conceive of these two conditions as relationships which exist between current prices and some other standard of value or worth. Many investors and a number of services employ the concept of intrinsic value as such a standard, and define it as a

reasonable capitalization of earning power. In order to know the earning power of a security, however, one must know something about the future. He may not forecast the exact earnings for any particular future period but he must, at least, know something about the normal or the equilibrium about which earnings may be expected to fluctuate. This knowledge may be conceived as a long-term or a general forecast, or it may be thought of as knowledge pertaining to those present attributes of the thing itself which are enduring in their nature. It is immaterial whether a service express such information as a present fact or as a forecast. The important point is that such information enables investors to recognize "cheapness" and "dearness" of securities when those conditions exist, and thus it enables investors to reap handsome profits from short-term traders whenever the enthusiasm or the gloom of the latter causes them to bid stocks up to extremely high levels, or to dump them on the market at extremely low levels.

Some investors and some services do not employ the concept of intrinsic value for this purpose but use some other idea by which to recognize "cheapness" and "dearness." They may conceive of these conditions as relationships between current prices and the "normal" price level. Such a "normal" concept was used, at one time, by the Brookmire service. Babson, on the other hand, employs a concept which he expresses statistically in his X-Y line. These and similar concepts, like Marshall's concept of long-term equilibrium, are instruments by which one may recognize "cheapness" and "dearness," or "depression" and "inflation" when they exist. Only the recognition of these conditions is necessary to the long-term method of operation, although such recognition does imply certain general knowledge concerning the future, whether it is expressed or conceived as a forecast or as an attribute of the present.

DECLINING TENDENCY OF SECONDARY PROFITS

In the preceding article it was seen that market fluctuations present opportunities for individual traders to profit at the expense of other traders, but they do not present opportunities for the public to enrich itself because exchanging stocks among one

another does not increase wealth. Assuming that the clientele of any service may have advance knowledge of any market fluctuation, and assuming that this clientele may attempt to buy at the bottom of that movement and to sell at the top, the profit to the average member of the clientele will be limited, in part, by the size of the clientele itself, especially in relation to the size of the body of less skilful traders from whom profits are being obtained (both measured by the amount of funds employed). The larger the clientele in relation to the group of less skilful traders, the smaller is the potential profit to the average client.

This principle applies in substantially the same manner to the secondary profit derived by the clients of any long-term investors' service. The greater the buying power of the clientele in relation to that of less successful operators, the smaller will be the secondary profit to the average member of that clientele.

When the price of a stock is recognized by a service to be substantially lower than the value of that stock as indicated by its earning power, that service may advise its clients to buy, or it may issue a long-term forecast to the effect that the stock will eventually rise. In either case, the clientele of that service may buy the stock. Such purchases will tend to advance the price. The larger the clientele, the larger number of purchase orders may be expected and the greater effect these purchases will tend to have upon the market.

The average client probably will not be able to buy at the price which existed when the forecast or advice was issued. When the purchase order of the average client is executed the price may already have advanced several points. The number of points will depend, in part, upon the size of the clientele and the nature of the market, which includes the attitude of other operators toward the same stock. Obviously, orders to buy ten thousand shares of United States Steel common at the market will have less effect upon the price than would orders to buy an equal number of shares of some company which has a smaller number of shares outstanding and a smaller number actively traded from day to day. Making allowance for such differences in the condition of the market for different stocks, however, one must expect that

the larger the body of investors who are trying to follow the forecasts or recommendations of any service, the greater will be the discrepancy between the price at the time the recommendation is issued and that at which the purchase order of the average client will be executed.

Eventually, the price of the stock may tend to readjust itself to intrinsic value, as estimated by the service. In fact, the price may continue rising until it overshoots this equilibrium level. (Such an assumption seems to be necessary to the forecasting theory developed by Roger W. Babson.) When a long-term service believes the stock to have become overpriced on the market it may advise sale or predict that sooner or later the market will recede from existing levels. On such recommendation the clients of the service may wish to sell.

Again at the upper extreme, the market will tend to be affected by the sales of stock by the clientele itself. The price realized by the average client will probably fall short of the price which existed at the time the recommendation was issued. The larger the clientele, the greater may be the discrepancy between the price at the time of the release by the service and that which will be realized by the average client.

It should be obvious, therefore, that the secondary profit realized by the average client on each purchase and sale transaction may tend to decline as the clientele of the service increases in size and in buying power. In other words, the potential secondary profit of the average client of a long-term investors' service may tend, within certain limits, to decline as the size of the clientele of that service increases.

LIMITS OF DECLINING TENDENCY

This declining tendency of secondary profits differs, however, in one important characteristic from the declining tendency of total potential profits to the average client of any short-term traders' service. In the case of the traders' service it has been observed that all profit to the average client may be replaced with a loss when the clientele becomes too large, even though each forecast of the service seemed "perfect" if judged by the

subsequent performance of the market. But in the case of the secondary profit of the average long-term operator, the declining tendency may extend toward zero but no conceivable increase in clientele would replace the profit with a loss if the service is assumed to be successful in estimating intrinsic values or forecasting future earnings or determining the equilibrium about which prices will tend to fluctuate.

The limit to the declining tendency of secondary profits would seem to be just enough profit to justify trading. This limit would not be reached until all the operators in the market became followers of the same successful service or of other services which were equally successful or until they became equally skilful themselves in determining the current intrinsic values of securities and in projecting them into the future in one form or another. There would seem to be no absolute limit to the distance into the future that investors and service enterprises might try to predict earnings, but there will be a practical limit. Also there will be a practical limit to the amount of skill which may be attainable in this respect. But even if one assumed that all operators were equally skilful in estimating intrinsic values and in projecting them into the future, the limit to the declining tendency of secondary profits would be reached when the price of a stock were adjusted to approximately the level of intrinsic values. Beyond that point there would be no incentive for any long-term operator to buy or sell except as he might need to withdraw funds from the market or as he might have new funds to invest. The action of long-term investors would tend to cause the market to adjust itself to the level of intrinsic values, but it would not cause it to overshoot that level because there would be no incentive for such operators to sell more stock after the price had fallen to that level or to buy more stock after the price had risen to that level.

In other words, the effect of an increase in clientele of a skilful long-term investors' service may be to produce a tendency toward the reduction of the secondary profits of the most fortunate long-term operator, but such profit would not be wiped out unless all investors assumed the long-term point of view and came to a virtual agreement upon the intrinsic values of all securities, and

even under that assumption, it would not be replaced by a loss to anyone. Even if one assumes that this state of affairs may ever exist, which is an enormous assumption, trading would merely be reduced to a minimum as the market became inactive around the level of intrinsic values.

ABSENCE OF INJURIOUS REPERCUSSIONS

Since no conceivable amount of increase of the clientele of a long-term investors' service will produce loss to any of its clients, if the service is successful in determining intrinsic values, there will be no tendency toward repercussions of the nature which was described in the discussion of traders' services. It will be remembered that such repercussions arise when traders believe that the profit to the average follower of the recommendations has declined to a point which is so low (probably a minus quantity) that the operator has a better chance of profit by departing from the recommendations and trading in some other manner. Such a point can never be reached in the case of long-term services.

No conceivable amount of increase in the clientele of a service can do more than reduce the secondary profit to a minimum It will not be converted into a loss and the primary profit will not be impaired. Therefore, assuming skill on the part of the service in determining intrinsic values, the most profitable course for each investor will always be to buy stocks which are offered below that level and to sell those which may be priced above it. There will be no conceivable manner for the long-term operator to make more by trading contrary to the advice of the service. The operator who might try to do so would lose upon every transaction.

TENDENCY TOWARD STABILITY

Because of the absence of injurious repercussions when a service of this class acquires a large clientele, its clientele will probably tend to increase as its skill increases. And, as its clientele increases, its influence upon the market will tend to become more important. This influence produced by each individual enterprise is a tendency for the market to adjust itself to the service's estimate of intrinsic values. Although the estimates of various enterprises will differ considerably, each enterprise will tend to in-

fluence the market in the direction of its estimate of intrinsic values. And since the services which have proved themselves to be most successful in determination of such values will probably gain the largest number of clients, they will gain the greatest influence upon the market, and this influence will be in the direction of the estimates which are probably the most nearly correct.

It is too much to expect that the market will ever be dominated by long-term investors who are clients of services which are able to determine intrinsic values accurately, but it is constructive to recognize that the net effect of all the tendencies produced by enterprises of this class will be a general tendency toward market stability at or near the level which represents a reasonable capitalization of earning power by those services which have been most successful and have thus acquired the largest clienteles. As services of this class become better recognized and more skilful it seems reasonable to expect that they will exert a noticeable effect on the market in the way of reducing the size of cyclical movements.

One of the reasons why the stabilizing tendency of this class of services has not been more easily noticed in the past is that the same generation which has witnessed the greatest development of services of this type has also witnessed the great development of services of the short-term class which produce market fluctuations instead of tending to stabilize the market. Even some of the leading service enterprises, such as Standard Statistics, publish several different service organs, some of which are designed to aid long-term investors and others to aid short-term traders. While the one type of service was exerting a tendency toward stability, the other was tending to produce fluctuation.

POSSIBLE EFFECTS ON PRIMARY PROFITS

There are several ways in which skilful service enterprises which are imbued with the long-term point of view seem to set in motion forces which tend to increase the primary investment profit. In other words, there seem to be several possibilities for such services to increase the wealth of the investing public as well as that of their clients.

By assisting their clients to predict the future income which will be derived from respective securities or to determine the intrinsic values of securities, service enterprises tend to facilitate the direction of savings into the most productive industries and into the most promising companies. They tend to direct it away from industries which are already overbuilt and away from companies which seem to be poorly managed or which seem, for any reason, to possess unfavorable prospects. Such direction of capital to the uses which appear to be most productive should tend to increase the average earnings of capital to the investing public.

For a number of illustrations of this principle one may look over the records of corporations which have failed. If services could have predicted with a reasonable degree of accuracy the earning power of any of those corporations before investors appropriated their funds to those respective purposes, the services would have prevented some of the losses to investors. Any such losses avoided would tend to raise the average rate of earnings upon all savings appropriated to investment purposes.

Furthermore, in so far as services imbued with the long-term point of view may assist investors to recognize when the market, in general, is too high or too low in relation to the prospects of industry, they will tend to forewarn industry of coming fluctuations.[6] And to the extent that services may assist investors to appropriate new funds to capital uses at the stage of the major cycles in which those funds will buy the largest amounts of capital goods, they will also tend to stabilize industry and will thus tend to increase the earnings of industry and to benefit society.

Therefore, to the extent that long-term investors' services may assist investors to determine intrinsic values, to forecast future earnings, or to foresee the major cyclical fluctuations of either the stock market or of industry, they will not only benefit their clients but will tend to benefit society. In other words, all investment counselors and other long-term service enterprises which succeed in producing profits for their own clients necessarily tend

[6] Cf. William Peter Hamilton, *The Stock Market Barometer* (New York: Harper & Bros., 1922).

to benefit society as well. This is in direct contrast to the adverse tendencies set in motion by short-term operators' services which, we have seen, tend to injure other members of society by amounts greater than the benefits gained by the most fortunate operators.

FACTUAL SERVICES

Since services of the long-term type seem to be free from the most serious limitations which beset traders' services, it seems proper to elaborate slightly upon the respective forms of service which fall within the long-term class. Special consideration is given to the possibilities for making all existing services even more useful than they may be at present.

The scope of factual information which is now offered to the investing public by well-known services is extensive, and this information is highly useful; but many large investors, especially institutional investors, find it necessary to go beyond such information for data which they consider necessary to prudent investment. Even such institutions as confine their investments to high-grade bonds often employ their own representatives to make detailed investigations of the affairs of a corporation or municipality before buying its bonds, and from time to time thereafter. Most of these investors already subscribe to several of the best-known factual services and, according to the reports received by the present writer, they are fairly well pleased with the factual information contained in such services as Moody's, Standard Statistics, etc. Such enterprises have received particular praise for their accuracy in compiling the information which they publish. The principal reason, therefore, for investors making direct investigations of debtor companies and municipalities is not that investors question the accuracy of published information. It is rather that they feel the need for much more information than can be obtained in published sources.

For instance, services publish financial statements without much detail. The balance sheet of a corporation may show real estate at a certain figure less a certain amount of depreciation (or it may merely show the net amount after depreciation), but the service seldom states the depreciation policy or the formula by

which the depreciation has been determined by the company's accountants. Although a brief description of the property is published, the conservative investor wants much more information about the property. He wants to know the age of buildings, their state of repair and probable life, their probable quick-sale value, and perhaps the amount which it would cost to replace them under current conditions. With such information the investor may be able to detect that one corporation has much more conservatively evaluated its properties on its financial statements than another debtor who's bonds may be selling in the same price class.

Or to use another illustration: The services usually publish the names of the principal officers of a corporation but they seldom publish much additional information about them. Through credit bureaus investors may be able to obtain, at some cost, a limited amount of additional information pertaining to the integrity of these executives. But even then conservative investors often want much more detailed information about these men before entrusting to them institutional funds or life savings. The investor must rely upon the efficiency as well as the integrity of the personnel of debtor corporations and municipalities.

If stocks are to be included in a portfolio the investor has even greater need for detailed and reliable facts concerning the enterprise in which he invests. The more information he can obtain concerning its business, especially in relation to competitive conditions, the more intelligently and safely he can invest his money. In practice, however, the average stock buyer is not as well informed on the affairs of the company in which he invests as is the average institutional buyer of its bonds.

The difficulty of obtaining adequate information pertaining to stocks, especially, has caused many investors to assume the short-term trading attitude who would otherwise be long-term investors. They have been led to believe that detailed information in regard to a company is unnecessary if the investor stands ready to sell upon the first signs of danger. He fails to recognize that danger signals may already be apparent to the best-informed investors, and if he buys without thorough investigation he may be accepting the stock which better-informed investors are anxi-

ous to dispose of. When he, in turn, sees the danger and wishes to sell he will be able to receive no more for the stock than others are willing to pay who have equally as good an opportunity to see the danger. That such a shortsighted type of investment is not likely to produce profits commensurate with the risks involved was pointed out in the preceding article.

The investing public is, therefore, faced with the gigantic problem of finding the necessary information pertaining to all the enterprises which are to be publicly financed. It is inconceivable that any investor can obtain the information which is required for prudent investment in a diversified list of securities without the aid of service enterprises, unless he confines his investment to his local community—a policy which would deprive him of the advantages of geographical diversification. Service enterprises have an opportunity to supply the necessary information for intelligent long-term investment, and it is to them that investors of the future will look for such data.

FORECASTING SERVICES

Many investors have admitted that factual information is important but they doubt that forecasting services are likely to benefit them. This skepticism has arisen, in no small measure, from the fact that those investment-forecasting services which have been most widely advertised and have gained the greatest notice have engaged either exclusively or largely in short-term forecasting; and since that type of forecasting has not proved successful, the inference is readily drawn that investment forecasting is a failure. A little thought, however, should convince any skeptic that there is an abundance of evidence all about us indicating the practical success of long-term investment forecasting.

Without predicting business profits, no business man would be justified in undertaking any business venture. Without forecasting the probable future income which will be derived from investing resources in some enterprise, there would never be any justification for the appropriation of funds to productive capital purposes. Of course such necessary forecasts are not predictions of

the short-term type; they are not even specific; all that is necessary is that one recognize that the earnings from capital invested in a certain manner are likely to be above that level which is just sufficient to justify the appropriation. Such forecasts are general, long-term predictions. Unless the degree of success in such investment forecasting is much higher than could be accounted for by the incidence of chance, investment losses would greatly exceed gains because there is certainly an infinite number of ways in which one might squander and lose his resources compared with a limited number of ways in which he can appropriate them to productive purposes. The historical periods in which the net investment gains made by society at large were the greatest, must be the periods in which the average degree of success of investment forecasting was the highest. The industrial progress of a country is an objective indication of the success of its people in long-term or true investment forecasting.

Undoubtedly the most important types of investment forecasts are those which pertain directly to the future income (dividends and interest) which may be expected by the owner of stocks and bonds. When long-term price forecasts are based upon such predictions they become almost as important as the predictions which pertain directly to earning power. Predictions pertaining to the rate of business activity and the prospects for business profits, either in respective industries or in general, assist business men to so manage their affairs as to increase earnings—the primary source of investment income. Forecasts pertaining to commodity price levels seem also to be quite important, especially in the bearing which they have upon prospects for business prosperity.

However, the scope of investment forecasting extends far beyond the types which are commonly found in service publications. Many forecasts having investment significance may be found in unexpected places. Jevons and others have suggested seeking such forecasts in the study of sun spots. They may also be found in scientific journals of all kinds. Industrial enterprises often employ scientists in their laboratories to seek scientific information which may be useful for business and investment purposes. Any

bit of such information which can be made useful to industry or to investors can be expressed in the form of an investment forecast of the long-term or general type. Hence, for one to challenge the possibility of scientific investment forecasting is to challenge the possibility of science itself. The limits of the possibilities of useful investment forecasts are the limits of scientific information upon such subject matter as may, conceivably, have some bearing upon the economic affairs of man. To argue that such forecasting is impossible is to argue the impossibility of science, industry, and even civilization itself; to argue that such forecasts defeat themselves when made available to the public by service enterprises is to argue that industry defeats itself when it is recognized by the public.[7]

COUNSELOR SERVICES

The majority of investors recognize the rich opportunities of factual services to render valuable aid to investors; a smaller number recognize the possibility of valuable investment forecasting; but in regard to investment counsel or advice the attitude of the general public seems to be expressed in the trite quotation, "Seek facts diligently, but advice never." But the need of the public for sound investment advice seems to the writer to be equally as great as for either facts or forecasts.

Industry has become almost inconceivably complex, especially in the last fifty or seventy-five years. If factual and forecasting services were to furnish investors with a body of information and of long-term forecast concerning all investment securities similar in completeness and detail to that which investors a few generations ago demanded in regard to their investments, then factual and forecasting services would become so complex that no unaided investor could read and comprehend all the available information relevant to the management of a diversified portfolio. In other words, there is a human limit to the amount of factual and forecasting material which any investor may digest and use intelligently. Many large investors have already obtained even more

[7] Contrast Oskar Morgenstern, *Wirtschaftsprognose* (Wien: Julius Springer, 1928).

information than they can use to good advantage. As even more valuable information is made available to investors, the proper use of this information will require more and more time and skill on the part of the investor.

Many intelligent investors have already recognized this fact. Some of them have turned to investment counselors for assistance. Others, including many institutional investors, have employed staffs of experienced security analysts and investment experts as the only intelligent alternative to that of patronizing professional investment counselors. Since the latter, however, make their services available to more than one client, the cost to each investor is only a fraction of what it would be if he employed his own staff of advisers to assist him. If his objective were a short-term objective, then advice pertaining thereto would tend to defeat itself when made available to other investors; but if the investor's objectives are of the long-term investment type, then the release by the counselor of equally good advice to other investors will merely tend to stabilize both the stock market and industry. While it may tend to reduce the secondary profit of the most fortunate investor it will not tend to convert that profit into a loss, and it will tend to increase the primary profits of the average investor as well as those of the most successful investor.

The most important types of investment advice seem to be those which pertain directly to the three following portions of the investor's task: first, investment planning, which includes analysis of his special requirements, determination of reasonable objectives which are consistent with his needs, and selection of an investment policy which is well suited to the attainment of those objectives; second, investment research, which includes analysis of factual data and available forecasts for the purpose of selection of particular security issues consistent with the investment policy which has been determined; and, third, execution of the whole program in a manner consistent with the predetermined policy and with the results of investment research, and also consistent with current developments as they occur from time to time. The latter function of advice is particularly important because it involves advising the investor to act when circumstances require

action, and advising him to refrain from rash action on the impulse of the moment at times when overenthusiasm or pessimism might impair his judgment. Therefore, this function of advice should be particularly beneficial to society in tending to ameliorate cyclical fluctuations of both the stock market and of industry.

SUMMARY

The distinction which has been developed herein between short-term or turn-in-the-market types of service, which seem futile, and long-term or intrinsic-value types of service, which appear useful, is believed to be the first precise statement of a logically tenable distinction between that which seems hopeless in the service field and that which shows encouraging possibilities. Many experienced investors may have felt this distinction, in a general way, as indicated by their behavior even more than by their words, but all attempts which have been found to state it scientifically seem unsatisfactory. The commonest such attempt seems to have been to try to distinguish factual services from forecasting services, but the present study shows that both factual and forecasting forms of service are useful when applied to long-term objectives and are equally futile when applied to short-term objectives. The nearest approach which has been found in the literature to the distinction which has been here developed is that drawn by Dow between two types of trading. However, he never summarized his philosophy or attempted to show what significance his distinction might have upon services. Since his death it has been almost forgotten.

The present analysis of the situation from the point of view of the clientele of the investors' services is believed to disclose the true nature of the unsoundness of the short-term point of view as an investment policy. Short-term objectives are unsound for the investing public because they are not attainable by the average investor, and never can be. Although some skilful traders may gain such profits from less skilful traders, no conceivable increase in the average skill of the investing public can enable that public to enrich itself by seeking such profits from itself. Hence, service enterprises which adopt this short-term point of view can never

hope to enrich the public, and any apparent degree of success in enabling their clients to profit from others will tend to defeat itself in the course of time.

Perhaps the broadest scientific significance of this study lies in its bearing upon the question of the nature of scientific economic forecasting. Various writers such as Morgenstern, Cowles, Graham and Dodd, and others, who have conceived of useful economic forecasts as definite predictions of the occurrence of particular events at certain times and places, have been inclined to pronounce economic forecasting as unscientific and unreliable. They have presented much evidence tending to show the impossibility of such forecasting, and the first portion of this study tends to confirm some of their findings in regard to such specific prediction, especially when it is applied to the stock market.

Certain others, including William Wallace and an enormous number of business men and investors, have conceived of economic forecasting as something broader and more general in its nature. With such concepts of forecasting they have regarded it as indispensable to business and investment and they have recognized many evidences of success in such predictions. This study seems to confirm their confidence in the possibility of successful economic forecasting as they appear to have conceived it, although most of them have not attempted to define it precisely.

In the light of this study scientific economic forecasting seems to consist in the statement of that which may be known concerning the future, much or little as it may be, after study of the enduring or recurring qualities of things, and the enduring or recurring forces or tendencies which affect economic events. It does not consist in predicting the occurrence of particular events at certain times and places, because particular economic events may be affected, to some extent, by unknown forces as well as by known forces or tendencies. In short, scientific forecasting might be defined as the search for knowledge pertaining to the future and the statement of that which is known concerning the future in such general or qualified terms as to avoid embracing something which is not known.